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Encouraging Company Rescue

A Response by the Scottish Technical Committee of R3 to the consultation by The Insolvency Service

About R3

1 R3, the Insolvency Trade Body, represents 97% of all licensed Insolvency Practitioners (IPs) in the United Kingdom who help individuals and businesses in financial trouble. There are approximately 1,700 IPs in the UK, who are licensed and regulated to give best advice and apply statutory, licensed procedures. Whether as accountants or lawyers, IPs deal with personal and business insolvencies, from large to small businesses; and help from 'turnaround' to formal insolvency procedures. 89% of IPs state that they give their first hour of advice for free.

2 There are 115 IPs in Scotland working in businesses of all sizes – 36% of IPs work in businesses of five employees or less with 18% working in very large businesses of 5,000 employees or more.

About the Scottish Technical Committee

3 The Committee comprises 12 IPs and 6 Insolvency Lawyers whose role is to support the General Technical Committee of R3 by providing comment and advice on the operation of Insolvency Law, Regulations and Rules in Scotland and commenting on issues which are of concern to IPs. The Committee does not include any representation from the Creditor or lending communities in Scotland.

The Consultation

Introduction

4 Before addressing the consultation proposals, we would confirm that we believe that Scotland currently has an effective and robust statutory corporate insolvency regime. We have expressed elsewhere our concerns that the legislative process currently disadvantages Scotland in not providing adequate opportunity to remedy perceived difficulties speedily and effectively.

5 We consider the administration regime as amended by the Enterprise Act 2002 to be clear, fairly well understood, and broadly fair as regards all stakeholders, but it has not generally achieved its objective of rescuing companies by allowing them an opportunity to restructure themselves.

6 We would like to stress that many of the proposals have important implications for lenders on which the Committee is not fully qualified to comment, and accordingly we are of the opinion that the views of the lending community will need to be considered very carefully.

Proposal A – Extending the Small Company Moratorium

7 We broadly welcome this suggestion as we can see no principled basis for treating companies differently depending only on size at the time of getting in to financial difficulty.

8 We share the concerns expressed by others however as to how widely this will be used or whether it will make a significant difference.

9 We are not clear as to the reasons why comparatively fewer CVAs have been proposed or implemented in Scotland in comparison to the rest of the UK, and without being able to attribute the reasons for this, it is difficult to assess the impact of the proposed change. It has been suggested that the procedure places too much responsibility (and therefore reputational and commercial risk) on the nominee who has a high degree of responsibility for matters which are not usually within his sphere of control. Such a risk may be considered higher in a larger entity.

10 On the other hand, it has been suggested that costs may be a significant deterrent factor. They may be presumed to be proportionately less in a larger entity, but the impact of cost on a financially distressed company is proportionately greater, and a change may therefore have less impact as a result.

11 We believe there may be merit in extending the moratorium to cover the period before finalising the proposal, and are attracted to the idea of its covering the prior period provided an IP reasonably considers it may be achievable.

12 We would express some concern however as to whether the implied exercise of discretion by an IP in these circumstances will not lead to disgruntled creditors discrediting the extension by attacking the exercise of discretion or the independence of IPs in doing so.

13 We would also express some concern about the definition of the commencement and termination dates for the moratorium in these circumstances.

Proposal B – Court sanctioned moratorium

14 Whilst in principle this proposal seems worthwhile, and we would agree that if implemented an initial 42 days extendable to 3 months would be attractive, we are concerned about the proposed tests and the suggested role of the IP.

15 If a court sanctioned moratorium is to be granted before a formal proposal has been worked up, we fear it may be extremely difficult to satisfy the proposed tests of (a) demonstrating a reasonable prospect of the CVA being approved and (b) demonstrating that a moratorium is in the interests of creditors taken as a whole.

These imply that a fair amount of due diligence will have to be carried out before an application to court, and it is difficult to see where the case to be put to the court can stop short of a fully worked out proposal to be sufficiently capable of satisfying these tests.

16 In this respect, courts may be reluctant to grant a moratorium ex parte on only limited information where the view of an IP is likely to be heavily caveated.

17 Care would be required to set the parameters on what we expected to be provided to a Court, so as to avoid a repetition of the growing burden, cost and delays to the process which came to be seen as one of the major defects of the 1986 Administration regime which Rule 2.2 reports.

18 We are divided in our views over whether such a proposal may be useful in cases where an unexpected major crisis engulfs and threatens the existence of a company which is otherwise sound but may need some time to ride out the crisis. There is a body of opinion which suggests the appropriate route in such cases would be administration followed by a CVA, we are less confident of its use in a more general insolvency situation.

19 We would consider that some safeguards may be needed against less principled use of this stratagem to delay the inevitable or protect those who ought to have been addressing the situation earlier.

Proposal C – Super-Priority of rescue finance in administration expenses

20 If the proposal is to improve the ranking of such funding as against the properly incurred outlays of the administrator and his remuneration, the effect will be to increase substantially the risk assumed by an IP acting as administrator and it is difficult to see how this would improve the prospects for administration achieving a successful rescue.

21 It should also be borne in mind that however high the priority accorded such finance, it will remain a matter of risk assessment for the lender as to whether the administration estate is likely to be able to make repayment, and it is not necessarily the case in all administrations that additional loan funds will increase the assets available to fund the administration or improve the chances of a successful outcome. Priority is only an issue where there is a deficiency to meet the expenses of the process, which by definition will be the less successful cases.

22 We are not clear whether the consultation paper intends “rescue finance” to be additional loan funds made to the administrator post appointment or is intended to be more extensive as suggested by references to the “availability of credit” and to “trade and services suppliers” in paragraph 61. If the latter, we believe a great deal of care will be required on definitions as we can foresee disputes on how to categorise additional credit extended post administration.

23 If for example trade creditors were able to attain a priority ranking as against other creditors in the administration, it might become less attractive to trade with a company in administration, which in turn would discourage rescue.

24 We would also seek clarity as to whether the proposed legislative changes to priorities would be binding, or whether there would be scope for an IP to negotiate a side agreement with a creditor which might facilitate continued trading.

25 In essence therefore we strongly favour the current regime which allows a great deal of flexibility and therefore permits each case to be treated on its own facts, circumstances and merits. We therefore respond to question C1 in the negative.

Proposal D – Greater ability to create new secured charges in an administration

26 This proposal presupposes the existence of unencumbered assets. In our experience this is relatively rare in the current climate.

27 An administrator already has power to grant charges (Insolvency Act 1986 Schedule 1 paragraph 3). In practice this is seldom exercised, generally because the normal source of borrowing for the purposes of the administration will be the floating charge holder, who has no need to vary his existing security. There is also the question of risk assessment, as administrators exercising borrowing powers and granting security would generally wish to be confident of their ability as administrator to repay the borrowing and have the security discharged.

28 We adopt in the interests of brevity, as we agree with, the response of R3 to the consultation in paragraphs 20 – 33 inclusive of their response.

Proposal E – greater ability to create new secured charges in a CVA

29 We suspect that the proposed condition that the grant of such security is necessary to obtain such finance will become a routine stipulation in such cases where it is to be considered. It is otherwise in our view objectively very difficult to determine whether such a condition is required.

30 The inter-relationship between the proposed provision and the conditions of a CVA is not clear. Will these be part of the Statutory Framework within which the CVA has to be developed, or will they be capable of amendment or exclusion by the CVA itself?

31 We consider the proposal in paragraph 77 that existing chargeholders have the right to vote to the extent that their security may be lost is unfair and impossible of application. To considering voting rights as protection against the weakening of a secured creditor's position is unrealistic. It flies in the face of the first sentence of paragraph 75 recognising that existing chargeholders are entitled to adequate protection.

32 In the same connection, we cannot envisage a creditor surrendering his security or agreeing to prejudice its priority of ranking, and would be interested to know how the government would intend to address the question of priorities among securities in the event of taking this proposal further. Will a later security be given statutory priority over earlier (by date of grant) securities?

33 The proposals would seem likely to increase the likelihood of disagreement and dispute over the CVA proposal and thus at best delay its implementation and at worst jeopardise its approval or increase the chances of rejection.

34 We do not consider the suggestion that the company could obtain insurance against the possibility of there being insufficient equity in its property to provide security for an existing fixed charge holder to be realistic.

Proposal F – Cessation of certain asset based Lending (ABL) arrangements on administration or CVA

35 We are in principle supportive of the idea that receivables collected by an insolvency office holder should be available to fund proceedings and therefore be available for distribution in due course. Such a provision however in our view will not necessarily improve the prospects of rescue as ABL facilities are generally supported by a floating charge and that might be expected to catch any short fall.

36 In our experience the existence of ABL facilities often impedes a rescue because the cashflow of the business is effectively strangled by the arrangement on the occurrence of an insolvency event.

G – Other Comments

37 The Committee welcomes the opportunity to contribute to the discussion of how best legislation can provide a mechanism to rescue businesses in difficulty. We would like to stress however that in many cases, rescuing a business is simply impossible and no amount of legislation will assist. There are several fundamental points which require to be emphasised:-

- at the point of entering an insolvency process, many businesses lack an adequate cash flow, and this has been further impacted in recent years by the growth of ABL arrangements. These are very useful mechanisms to make such available to trading businesses, but for an IP appointed to a business in trouble they severely restrict the possible cash flow from continuing to trade the business

- in the experience of the Committee, lenders prefer processes which place an IP firmly in charge of the ailing company. A CVA is less attractive than administration for the reason but the nominee/supervisor lacks the power to drive a restructuring and to look after the interests of creditors

- if a company has the scope within its existing arrangements to restructure, and has the support of its lenders, the restructuring is likely to take place without entering a formal insolvency process. The legislative framework therefore has to deal with the more challenging cases and is unlikely to be able to provide a statutory flexibility to equal an informal work-out arrangement

- the Committee is concerned that any legislative attempt to weaken or vary lenders' rights in insolvency of their customers will adversely affect the availability of credit or the cost of credit

- the Committee would challenge the perception that Chapter 11 in the United States offers a better solution than administration in the UK. Different lending structures in the USA offer more scope for DIP funding that is the case in the UK, and it seems to the Committee the cost of DIP funding is also very high in relative terms.

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